NATURAL GAS SUPPLY ASSOCIATION

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Mr. David S. Guzy, Chief
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Dear Mr. Guzy:

The following comments are in response to the Federal Register notice dated April 22, 1997, ("the Notice"), withdrawing the Minerals Management Service's ("MMS's") proposed rule on gas valuation issued November 6, 1995, ("Proposed Rule"), and requesting the public's views on two alternative options for natural gas valuation ("Alternative Options"). The Natural Gas Supply Association (NGSA) represents domestic integrated and independent companies that produce and market natural gas. NGSA participated actively in the lengthy "Negotiated Rulemaking" process that preceded and resulted in the Proposed Rule. Given our membership's interest in this matter, we hereby submit these comments.

Overview

NGSA believes that the Alternative Options offered by MMS would be, as a practical matter, more complex and less workable, and are clearly inferior to, the Proposed Rule withdrawn by the agency. In addition, we believe MMS lacks legal authority to adopt either Alternative Option at present, so it would waste the time and resources of the agency and the public to pursue either.

NGSA disagrees with many of the conclusions reached in the Notice, as well as with MMS's withdrawal of the Proposed Rule. MMS's decision to withdraw the Proposed Rule lacks rational basis and is not justified by the asserted reasons stated in the Notice. NGSA advocates a return to the Proposed Rule or adoption of a rule based upon the Unified Industry Proposals submitted in previous comments. If the MMS is not prepared to adopt either the Proposed Rule or one of the Unified Industry Proposals, then it should expeditiously pursue taking its royalty in kind ("Royalty-In Kind" or RIK) and marketing it. In that fashion, MMS can assure itself of receiving appropriate market value at the wellhead for its share of production, for it will be able to sell its RIK under an open, competitive-bid process. Our views on these matters are elaborated more thoroughly below.

Comments on the Administrative Process

NGSA is deeply disappointed and dismayed by the MMS's withdrawal of the Proposed Rule, which was based on a consensus agreement achieved from a long and costly negotiated rulemaking undertaken by the Federal Negotiated Rulemaking Committee, a group of representatives of a cross-section of industry, states and the federal government. We and other interested associations and industry representatives have devoted a considerable amount of time and effort to the negotiated rulemaking process commenced by the MMS over three years ago. Despite three years of effort, MMS is no closer to a final rule now than when the process began. This is indeed unfortunate. This development will no doubt chill future industry participation in any other negotiated rulemaking.

Comments on the Withdrawal of the Proposed Rule

In the Notice, the MMS withdraws its Proposed Rule and requests comments on two Alternative Options for natural gas valuation. MMS articulates five reasons for abandoning the Proposed Rule, and supports its conclusions with an internal study (hereinafter "MMS Study"). The reasons cited in the Notice for the withdrawal are invalid and fail to provide a rational basis for abandoning the Proposed Rule. Moreover, a number of these stated reasons are belied by the cited MMS Study, which allegedly undergirds the MMS decision to withdraw the Proposed Rule. The

Alternative Options suggested by MMS ironically share the same or even an increased degree of the infirmities MMS found in the Proposed Rule.

The first reason offered for the withdrawal is that the natural gas market is still undergoing dramatic change. While the industry may still be evolving, the substantive regulatory issues promoting that change were settled in the Federal Energy Regulatory Commission's ("FERC's") Order 636. Today, FERC is fine-tuning its regulations to ensure the best possible functioning of the marketplace. FERC recently initiated PL97-1 (Issues and Priorities for the Natural Gas Industry) and held public hearings in that docket in May 1997, to ascertain whether it can further loosen its already substantially reduced regulatory control over interstate pipelines and whether there is more it can do to promote unbundling of transportation services from merchant sales at the state level. The issues now under consideration at FERC would seem to have little or no impact on the collection of royalties or royalty valuation standards. Any resulting FERC action in PL97-1 would only accelerate evolving unbundling efforts. The ongoing industry changes toward further deregulation and reliance on market forces that were cited in the Notice do not appear to be valid reasons for withdrawing the Proposed Rule. If anything, these changes should prompt MMS to act quickly to make the Proposed Rule final. The fact remains that the industry has already changed markedly from conditions presupposed when the current regulations were propounded. Rule changes are needed now to reflect the changes which have occurred. That the industry may change yet again in the future does not justify failing to change gas valuation rules immediately to catch up with current reality. Possible future changes in gas markets at best may mean that rules could need to change again in the future. The potential of further future changes in marketing does not justify failure to act now to accommodate changes that have already occurred.

MMS asserts as its second reason for withdrawing the proposal that existing regulations are flexible enough to face the changes in the marketplace. This is patently incorrect. Some would contend that current MMS regulations were not sufficiently flexible to handle market conditions existing at the time they were implemented, let alone sufficient to respond to the sea-change in marketing that has since occurred. MMS initiated this rulemaking because, as its officials have stated on numerous public occasions, the current regulations are unworkable given the structure of today's natural gas industry. Indeed, the cited MMS Study repeatedly concluded that valuation of gas sold through pools, market centers and hubs has become increasingly complex, administratively unworkable, costly and unreliable under current regulations. The MMS Study repeatedly emphasizes the need to change current regulations.

The third cited reason for withdrawing the Proposed Rule is that published indices are "not developed enough to represent gross proceeds." NGSA strongly disagrees with this rationale and finds the statement perplexing.

In December 1995, NGSA submitted a study for the record that compared how accurately published gas price indices represent actual wellhead values reported to MMS (Foster's Study). The Foster's Study concluded, among other things, that an extremely high correlation exists between actual reported prices and index prices. The Foster's Study based its assessment upon publicly available data from MMS's own files on Outer Continental Shelf (OCS) production, which the MMS has neither refuted nor even discussed. MMS's conclusion is arbitrary and capricious to the extent that it ignored record evidence indicating that payments based on index prices would substantially approximate the MMS's current gross proceeds.

As a fourth reason for abandoning the Proposed Rule, MMS asserts that "[i]n the absence of published indices that accurately represent fair market value, any rule using these indices would inevitably become complicated because of the requirement to compare them to gross proceeds." MMS concludes that making this comparison would place a significant burden on MMS. There are three embedded conclusions interwoven in this fourth rationale. MMS's conclusions assume: a) published index prices do not reflect fair market value for gas, b) therefore, a "true-up" to a safety net calculation based on gross proceeds must occur, and c) this safety net/gross proceeds comparison has to be complex and burdensome, so much so that the Proposed Rule must be dropped.

As to the first assumption, how did MMS conclude that published indices do not reflect market value? There is no record support for this sweeping conclusion. The cited MMS Study summarizes the results of a series of interviews MMS conducted with companies and individuals actively involved in gas marketing. All uniformly reported using the various published indices to price the gas they buy and sell on the spot market, and they reported high confidence that the indices reflected market value. It would seem the MMS Study would force a conclusion that index prices are accepted as equal to market value by most industry participants. The Foster's Study also concluded that the majority of gas in the U.S. is purchased and sold based on these published index prices. In addition, many industry commentors who filed public comments on the Proposed Rule, as well as those who filed in the overall valuation comment process, indicated routinely buying and selling much of their gas referenced to published index prices. Query: If the majority of parties actually buying and selling gas in today's gas marketplace routinely price their commodity based on these published indices and routinely accept these indices as reflecting market value for their gas, is not this strong evidence that index prices equal market value? The record before MMS strongly supports concluding that index prices reflect market values. Indeed, what evidence exists to support MMS's current contention that published index prices do not equal market value? MMS has cited nothing. This assertion is, at present, without foundation in the record before MMS.

Next, MMS makes a two-fold assumption that safety net calculations must be made based on a comparison of index prices to someone's gross proceeds, and MMS further assumes that this analysis must be complex and burdensome. MMS's asserted need to conduct a safety-net calculation apparently rests solely upon its assumption that price indices do not reflect market value. This assumption, as noted above, is not based on evidence in this record. It is an unsupported bias or supposition. But assuming, for the sake of argument, that a safety net calculation is somehow necessary, it does not logically follow that the process needs to be as complex and burdensome as the MMS would make it. NGSA had joined with other industry representatives and trade associations to support Unified Industry Proposals submitted in response to the MMS's last request for comments on gas valuation options. The Unified Industry Proposals described how safety-net calculations could be conducted in a fairly simple, straight-forward, and non-burdensome manner. The Unified Industry Proposals demonstrate that a safety-net calculation, if it needs to be done at all, can be achieved with relative administrative ease if MMS chooses a simplified approach to the process. That MMS could turn the process into a complex, burdensome undertaking does not justify abandoning the Proposed Rule.

The final rationale for withdrawing the Proposed Rule is MMS's claim that a cost/benefit analysis of the Proposed Rule showed it is not revenue neutral and results in a potential annual deficit of $20 million. MMS based its conclusion on the MMS Study. This argument is equally as flawed as the above justifications. Again, the Foster's Study NGSA commissioned found that, overall, the use of published index prices in calculating royalty payments for gas sold under non-dedicated contracts would approximate gross proceeds based royalty payments to the MMS.

The MMS Study, which looked at a different reporting year of data than did the Foster's Study, and which made several assumptions and adjustments not made in the Foster's Study, concluded that MMS could suffer a $20 million shortfall.

The MMS Study conclusions seem counterintuitive. Many price indices report prices based on the average prices, or most frequently quoted prices, for gas sales at a particular delivery point. One would therefore expect any representative sample of actual sales made at the same point as the reported index points to average out at the reported index prices. Yet, under MMS's analysis, apparently most federal gas is sold at above these index prices. Like the fictitious town of Lake Woebegone, Minnesota, where "All the children are above average," most federal gas is mysteriously and consistently "above average".* NGSA suspects that differing results reached by the MMS Study, in comparison to the Foster's Study, may reflect MMS's methodology for adjusting for transportation deductions and perhaps adjustments based on its safety-net calculations.

The MMS Study's validity hinges upon MMS's assumptions about the past and potential behavior of a handful of top payors. If MMS changed its assumptions, the MMS Study results could change markedly. For example, if the selected assumed index payors did not opt to pay on index, the MMS Study's results would change. Further, MMS has assumed these selected payors paid correctly during the Study years. The past royalty payment practices of some of the selected payors may indicate

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* Keillor, Garrison, Leaving Home: A Collection of Lake Woebegone Stories, Viking Penguin, Inc. (1987)

that MMS has been sharing in downstream values that MMS is not entitled to receive. These payors may not have deducted, or been allowed by MMS to deduct, their full cost of downstream marketing, which could have resulted in overpayments. In short, the selected payors may have been overpaying royalty. Further, their past payments may reflect unique contracts those payors enjoyed that enabled them to out-perform the market during the year MMS studied. As those contracts expire, payments from these payors could fall to index.

Moreover, the MMS Study deducted from assumed index-based royalty payments the average transportation expenses reported by the selected top royalty payors as a deduction from their gross proceeds. In so doing, the MMS Study may have overstated the likely index payors' transportation expense to the index points. This would correspondingly have understated the likely revenues that index-based royalty payments would have yielded. The gross proceeds payors' transportation expenses may have reflected downstream marketing activities with correspondingly higher mainline transportation and storage costs. Transportation expenses from a wellhead to an index point should, on average, be lower than the expense of transport to an LDC city-gate. Therefore, index payors should be deducting lower transportation expenses than would gross proceeds payors, who are incurring transportation costs to some downstream point. It is not logical to assume that index payors would experience the same average deductions as gross proceeds payors. MMS should make its study data available to NGSA and other parties so that they could pursue an independent review of these critical MMS Study results.

Comments on Alternative Options

MMS suggests consideration of either an "index based approach with a +/- true up factor", or alternatively, what it calls the "Norwegian Board" approach. Both of the MMS's Alternative Options appear to include the objectionable notion that royalties should be based not just on the value of gas at the lease but also on the value of downstream marketing activities. NGSA would oppose this feature of any valuation concept.

MMS appears to have lost sight of its ultimate goal in pursuing a revision to its gas royalty valuation rules. Let us briefly recap what prompted the Proposed Rule. Existing regulations call for payment of royalty on a lessee's "gross proceeds" at the lease, in the case of arms-length sales, and on the basis of a set of benchmarks in the case of non-arms-length sales. A series of disputes have arisen between lessees and the MMS over the interpretation of these regulations. With the entry of producers into multiple direct downstream market sales, it is increasingly difficult to establish gross proceeds at the lease. Moreover, there has been a rise in non-arms-length sales as more producers have become involved in mergers or partnerships resulting in sales to marketing companies affiliated in some way with the lessees. They therefore have found their sales technically governed by the MMS's existing benchmark regulations, which the MMS has largely ignored in application. Instead, MMS has sought to reinterpret these regulations as requiring royalty to be paid on a lessee's affiliates' gross proceeds for downstream sales, rather than the stated benchmarks. MMS has not confined itself to valuing gas at the lease.

To extricate itself and the industry from an impending morass of litigation over the interpretation of these regulations, MMS embarked upon fashioning a new rule that would create a clean slate for the future. It would establish a new, workable methodology for valuing non-arms-length sales and off-lease sales, approximating only lease values, and avoiding the illegal, confusing, imprecise, and administratively burdensome efforts to chase downstream values for city-gate sales, some of which are achieved by marketing companies affiliated with the lessees. The Proposed Rule was designed to accomplish this objective.

Instead of fulfilling its objectives, the MMS offers two Alternative Options, which are thinly veiled new approaches for chasing downstream values largely achieved by marketing companies affiliated with lessees. In so doing, MMS has wildly strayed from its task of developing an appropriate methodology for valuing gas at the lease. This course of action would plunge MMS and the industry more deeply into the mire of litigation that the Proposed Rule was designed to avoid.

NGSA believes strongly that government is not entitled to benefit from the additional downstream risk undertaken by a lessee or by marketing companies. NGSA also believes that the attempt to benefit from these downstream activities is a flagrant violation of royalty statutes and leases. MMS's pursuit of such downstream values can only lead to disagreements that may ultimately be forced into the judicial arena, where previous interpretation of royalty statutes and leases make it abundantly clear that royalty should be valued at the wellhead and not at some point downstream.

The index-based approach with a +/- factor alternative is, ironically, based upon the same allegedly suspect "insufficiently developed" index-price approach that MMS has withdrawn in the Notice, with an added +/- factor that would substitute for the safety-net calculations. To the extent that the true-up +/- factor includes the value of downstream activities, it is illegitimate, in NGSA's view. Additionally it is subject to the same types of fluctuations and inherent "unreliabilities" that were cited by MMS as the grounds for rejecting the indexing option in the Proposed Rule. It is difficult to ascertain how MMS might be able to justify revenue neutrality or reliance on published indices for its +/- factor methodology if it cannot justify it for the Proposed Rule.
Further, this new indexing scheme appears just as complicated and burdensome as the safety-net proposal that the MMS saw fit to withdraw. Calculating the +/- factor would entail collecting gross proceeds data from marketing companies affiliated with index payors. MMS seeks to justify this as appropriately burdening those lessees who "benefit" from the reduction of administrative burdens, which MMS theorizes results from using an index-based payment approach. Unfortunately, the +/- factor would result in an overall doubling of a lessee's current administrative burden and yield no reduction in burdens. Additionally, it would impose new burdens on others not currently subject to MMS's data collection requirements. NGSA and others have stressed this point repeatedly in prior comments. Any arrangement that entails collecting data from and auditing the records of marketing companies affiliated with lessees is unacceptable.

Lessees with affiliated marketing companies would see no reduction, but rather see an increase in their reporting and administrative burden under this arrangement. They would have the dual burden of maintaining an existing costly and data-intensive computer system that attempts to track downstream sales; calculate a netback price; and store all sales contracts, invoices, records and accounts relating thereto. In addition, they would have to institute and maintain a new system to track, pay and justify index prices and deductions to the index points. Lessees would be forced to keep data for--and maintain at great cost--dual computer and accounting systems for the two royalty-payment approaches and stand ready to be audited under both systems. In essence, their administrative cost and burden would double if they became index payors.

The Norwegian Board alternative offers an intriguing approach that may merit further long-term study, but it does not solve our pressing immediate need for a workable methodology to value gas sold at the lease under non-arms-length sales or gas sold in off-lease, downstream sales. MMS lacks legal authority to implement it. Therefore, it is not a realistic alternative for meeting today's needs.

Norway's approach to crude oil valuation offers the twin positive benefits of achieving royalty-obligation certainty and closure for lessees, coupled with a reduction in administrative burden and costs. Lessees know in advance of payment what their royalty obligation will be, can pay accordingly, and achieve closure for those payment periods. Lessees in Norway are not constantly subject to retroactive examination of their past sales and royalty payments with attendant cost burdens and exposure to claims from several years' past royalty payments. This reduces lessees record keeping and accounting burdens and obviously reduces exposure to potential litigation. Replicating these benefits in America would be a worthy cause.

The particular solution adopted by Norway, the creation of an independent petroleum valuation board, could not occur in the United States without radical legislative change. To replicate what Norway has done would require the statutory creation of a federal royalty equivalent of the Federal Reserve Board used to set monetary policy. A federal royalty board, in order to achieve the degree of autonomy and independence enjoyed by the Federal Reserve Board, would need enabling legislation.

Further, Norway values oil based upon projected future values. Current statutes and leases call for valuing federal lease production at the time of production based on what the lessee in fact received for that production or upon that production's then-current market value at the lease. To move to a valuation on a projected or prospective value basis would require statutory change plus amending leases. Although this may be the subject of a long-term study, the industry needs more immediate regulatory guidance. MMS needs to focus on that which is within its current statutory authority to accomplis. rather than defer to some future act of Congress.

To the extent its current statutory authority permits, MMS could take upon itself some of the data collection activity that the Norwegian Board currently assumes in order for the MMS to compile its own comparison "index price" for wellhead sales. In so doing, the MMS would be taking on a more formidable and daunting task than currently faced by the Norwegian Board, and it is doubtful that this approach would pose any less of an administrative burden than the allegedly unduly burdensome "Proposed Rule." Participants in the Norwegian oil industry are a far smaller group of companies, with a far more limited array of sales arrangements, than those that characterize the United States's natural gas industry. The U.S. natural gas industry, in contrast to the Norwegian oil industry, is comprised of hundreds of buyers and sellers trading at dozens of sales points and engaging in thousands of transactions monthly. It is unlikely that MMS could capture easily the same amount of data on natural-gas transactions in the U.S. that the Norwegian Board is able to collect concerning Norwegian oil trades, due to the sheer volume of U.S. natural gas transactions as compared to Norwegian oil transactions. However, MMS may be able to develop a rational sampling system from which it could compile relevant current price data, from which it could then develop its own comparison "index price".

Of course, safeguards against error or bias in the price compilation would need to be built. MMS would need to make public its data and compilation methods so that the affected lessees could challenge the resulting comparison index. Moreover, to be lawful, MMS would have to focus on collecting data from lessees on wellhead or lease sales values, not on downstream city-gate sales.

It appears that part of the MMS's lack of confidence in currently used and quoted index prices is a concern that the sample of trades upon which the index prices are based may be too narrow. Perhaps MMS would be more comfortable with indices if a broader array of participants in the market place were furnishing price data to the index price compilers. If MMS established a system under which producers could quote to the MMS prices for which they were selling their production and prices at which they were purchasing production at certain index points, the MMS might be able to create a sufficiently broad sample to develop index prices in which MMS may have greater confidence to compare against the published trade press indices.

Conclusion

NGSA continues to support the Proposed Rule that grew out of the negotiated rulemaking process as the most viable, fair, and workable of all the royalty proposals now on the table. We urge MMS to reissue it as a final Rule and to move rapidly forward with its implementation. As an alternative, NGSA could also support any of the Unified Industry Proposals.

Of the Alternative Options presented for comment, MMS should abandon the index-based +/- factor concept as a non-starter. A system that requires lessees to maintain dual accounting and computer systems to both pay on index (and substantiate such payments) and to withstand an audit of affiliated company downstream sales as well would, in addition to its obvious legal infirmities, be so costly and burdensome to NGSA members that they could never agree to it. The Norwegian Board concept has laudable objectives, but is far beyond MMS's statutory authority to pursue. Further, the way MMS has described implementing it would violate royalty statutes and leases by 1) valuing gas on downstream sales activities and not on lease values and 2) requiring audits or data collection from marketing companies that are not lessees. As such, it should be dropped.

MMS's rejection of an approach to royalty valuation that was substantially agreed to in the negotiated rulemaking and its substitution of two at-present unworkable Alternative Options fuels the impetus behind proposals that the MMS implement a broad RIK program covering all major producing areas on federal lands, and that the royalties paid by lessees that market MMS's royalty share of production be benchmarked to prices that are achieved by the MMS through its RIK sales in the same producing areas. Lessees should be given the option to require MMS to take its royalty in kind. NGSA endorses this approach. We can certainly understand the growing support it is receiving.

Sincerely,

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